

EcoFlash

ECB: An adjustment, but not necessarily the start of a tightening cycle

As expected, the European Central Bank raised its key interest rates by 25 basis points, bringing the deposit facility rate to 2.25%. This decision, taken unanimously, reflects the Governing Council's conviction that the persistence of the energy shock warrants a monetary policy response. The ECB revised its inflation outlook upward more significantly than its growth forecasts downward. It also updated its alternative scenarios relative to the central scenario (one more favorable, two adverse). Christine Lagarde emphasized that today's decision was "robust" across all scenarios.

The persistence of inflation at the heart of the ECB's concerns. During the Q&A session, Christine Lagarde confirmed that the decision to raise rates was unanimous, unconditional, and that no alternative proposal was discussed during the meeting. The ECB President reiterated that future decisions will be made "meeting by meeting," based on available data and without a pre-set rate path. A new favorable scenario ("mild"), deemed unlikely, was added alongside the existing three scenarios (central, adverse, and severe). The severe scenario, in which inflation would deviate significantly and durably from the target, would call for an "appropriate and decisive" response. The communication framework has clearly evolved since the April meeting, with a stronger focus on the persistence of the inflationary shock rather than solely on the levels reached. Nevertheless, as Lagarde noted, long-term inflation expectations remain broadly well anchored around the 2% target – a reassuring signal for the ECB.

Upward revisions to inflation projections, with more persistent pressures. The ECB's new inflation projections for 2026 now sit midway between the central and adverse scenarios outlined in March. They reflect a combination of durably higher energy prices and more pronounced second-round effects, largely confined to food and industrial goods (excluding energy). The headline HICP inflation forecast has been raised to 3.0% (from 2.6%) for 2026 and to 2.3% (from 2.0%) for 2027. Core inflation is expected at 2.5% for both 2026 and 2027 (compared to 2.3% and 2.2% respectively). While our own forecasts for 2026–2027 incorporate a rise in core inflation in line with the ECB's projections, we anticipate more persistent pressures on agricultural and energy prices in 2027 (particularly gas/TTF prices). These translate into a higher total inflation forecast of 3.3% for 2027.

More limited growth revisions against a backdrop of resilience. The ECB's downward revisions to GDP growth are modest (-0.1 pp for both 2026 and 2027, to 0.8% and 1.2% respectively). The ECB expects some resilience in growth, supported notably by investment efforts in infrastructure, digital, and defence – the same pillars underpinning our recovery profile for activity in 2027 (1.6%).

Another rate hike expected, likely in September. At this stage, forward-looking price indicators (European Commission surveys and PMIs) confirm a gradual transmission of the energy shock to other sectors. However, the transmission remains less significant than what was observed in 2022 and still only marginally affects finished goods. The emergence of a price-wage spiral appears, for now, unlikely, as wage pressures should remain contained in 2026. The ECB anticipates a slowdown in compensation per employee growth to 3.2% in 2026, followed by stabilization at that level in 2027–2028, consistent with the 2% inflation target. In this context, we maintain our scenario of one additional 25 bp rate hike, most likely in September, followed by a plateau in 2027.

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